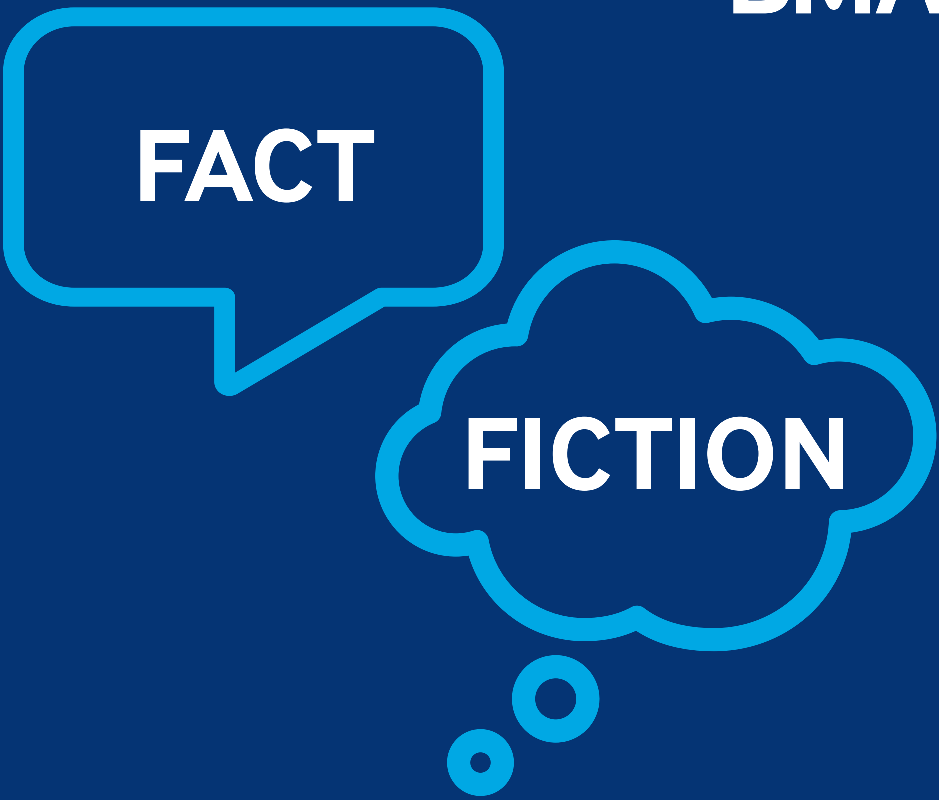
BMA



Fast facts – the AA (annual allowance) explained

This fact sheet is to inform you about AA tax charges, but we advise that you **must** still seek independent financial or taxation advice to verify your own situation.

British Medical Association
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FACT

A third of consultants received an AA tax bill in the last two years

The AA is the maximum amount your 'calculated' pension can grow in a given financial year without being subject to additional taxation. The AA was brought in by the Government as an attempt to limit the amount of tax relief available on pension savings. The AA was as high as £255,000 in 2010 but was reduced to £40,000 in 2014. As of 2016 this may reduce to as low as £10,000 if you are subject to 'tapering'. Although this sounds like a large amount, in the NHS pension scheme the amount put into the pension each year is multiplied by a factor of between 16 and 19 so small increases in pensionable pay can generate very large theoretical pension growth. With a three-year carry over this problem is only just becoming apparent for many consultants. Large numbers of consultants – we believe that 30% of consultants have received an AA charge over the last two years – have already been affected and this figure will continue to rise for the next 12-24 months. Modelling done by the BMA suggests **all** full-time and many part-time consultants will be affected by this additional tax charge during their career.

FICTION

You earned less than £100,000 so won't be affected

Unfortunately, this is certainly not the case. If your total taxable income from all sources is less than £110,000 (the 'threshold income') you retain the standard AA of £40,000 per year and you are not subject to tapering. It is a common misconception that you cannot get an AA charge with earnings below the threshold. However, it is still possible to generate large pension growth and exceed the £40,000 AA limit even if your total earnings are **below** £110,000. In addition, contrary to what is often quoted, tapering **doesn't** only apply to those **earning** over £150,000 (the 'adjusted income'). This adjusted income limit of £150,000 is your taxable pay **plus** any pension growth. Due to the way pension growth is calculated in the NHS, there can be large theoretical pension growth from a modest rise in pensionable pay and consequently a consultant with taxable earnings of just over £110,000 can be 'fully tapered' resulting in an available AA of only £10,000.

FACT

You may be paying to do additional work

Tapering of the AA results in a 'cliff edge' effect around the threshold income of £110,000. If your taxable income is below £110,000 then you are not subject to tapering. Consequently, you retain the standard AA regardless of how much your pension grows that year. If, however, your taxable income is just over £110,000 then you need to calculate your adjusted income. If this figure (your adjusted income) is over £150,000, your AA tapers by £1 for every £2 this figure is above £150,000. In the case of a consultant with a pension growth of £100,000 but a threshold income of £110,000, they retain a standard AA, but even as little as £1 of additional income would result in AA reducing to the minimum of £10,000. This £1 of extra income could increase the tax payable by £13,500.

FICTION

You are financially better off undertaking extra PAs (programmed activities)

If you are subject to tapering, ie you have breached both the threshold and adjusted Income levels, you may face effective tax rates of nearly 100%. This is because not only will you be paying income tax at a rate of 40-45%, you will be subject to 'tapering' of your AA. As outlined above, your AA reduces by £1 for every £2 your adjusted income is greater than £150,000. However, as this adjusted income includes your pension growth, this means that many consultants are subject to tapering of the AA even when their **earnings** are significantly below £150,000. In addition, your tax-free personal allowance starts to taper in a similar manner between £100,000 and £125,000 (for the 2019/20 tax year). The combination of these things results in effective tax rates of nearly 100% if you pay the AA tax charge from your take home pay. Nonsensically, if you use scheme pays to settle your AA tax charge instead, doing additional/extra PAs can result in you receiving a significantly **lower** pension.

FACT

Using scheme pays can result in a loan of £1m

The alternative to paying the AA charge yourself is to pay the charges from your final pension. This is known as 'scheme pays' and is effectively a loan secured against your pension savings. This loan is subject to a rate of interest that is equivalent to the CPI (Consumer Prices Index) plus the scheme discount rate (SCAPE rate). This combined interest rate has recently been as high as 5.8% and is currently 4.8%, ie a level higher than most mortgages. In Scotland, a slightly different calculation is applied but the effective interest rate is similar. The scheme pays loan is paid before assessment against the LTA (lifetime allowance) so this can be a good option for some people, particularly those closer to retirement, as it can help lower the tax charge payable for exceeding the LTA. However, for younger consultants, the high compound rate of interest can be crippling. Modelling done by the BMA demonstrated that a 40-year-old consultant may be servicing a scheme pays loan of nearly £1m if they were to continue working and contributing to the scheme until state pension age.

FACT

On the 2015 scheme you will pay more AA tax for a lower pension

There is a particular issue for those consultants who are members of both the 1995/2008 and 2015 pension sections. The pension growth is calculated separately for the different sections for the purpose of testing against the AA. However, accrual is closed in the 1995 and 2008 schemes so the only way pensions can grow in those schemes is by an increase in pensionable pay or, in the case of the 2008 scheme, the reckonable pay. In addition, in order to adjust for inflation your pension is able to increase up to the value of CPI before it is considered to be pension growth. Consequently, if you do not receive a pay increment or other rise in pensionable pay, the only way your 1995/2008 pension can grow is if your pensionable/reckonable pay increases by at least CPI. In years of sub inflationary pay awards, the value of pension actually falls and is negative growth. However, for the purpose of the AA this is considered to be £0 – ie zero growth rather than negative growth – and is **not offset** against any positive growth in the 2015 section. A further issue is that in the 2015 CARE (Career Averaged Revalued Earnings) scheme, your pension is increased by CPI +1.5%. This means that once a consultant who is in both schemes receives their first AA bill, they will receive a further and increasing bill every year, as they are unable to build up any carry forward of AA. Conversely, protected members who are fully in the 1995 scheme have unused AA in years without incremental pay rises that can be carried forward to absorb the impact of future pay rises. The combination of these effects is hugely significant. BMA modelling suggest that a 40-year-old consultant in both the 1995 and 2015 sections will have a scheme pays loan of nearly £1m at retirement, which would fall to just over £100,000, ie nearly 10 times lower at state pension age, if they had been able to remain fully in the 1995 scheme. This is despite the 1995 scheme delivering a significantly higher pension and a significant tax-free lump sum.

You didn’t receive a letter from NHS pensions so don’t need to worry

The NHS BSA (NHS Business Services Authority) will inform you, usually around October, if you have exceeded the standard AA of £40,000 in the preceding tax year. However, NHS BSA do not know what your total taxable income is, whether you are subject to tapering and therefore have a reduced AA. So, for example, you may have pension growth of £30,000 and hence not automatically receive a letter from NHS BSA. However, if your total taxable income is £160,000, this gives you an adjusted income of £190,000. Your AA is therefore reduced to £20,000 and you would be subject to an AA tax bill on the excess £10,000. Calculating this tax charge yourself is extremely challenging. We are aware of accountants, financial advisers and specialist pensions firms getting these calculations wrong. Even HMRC’s AA calculator was incorrect and had to be taken down from their website. In addition, receiving these letters from NHS pensions after the tax year has ended makes it impossible to take steps to mitigate against these punitive tax charges. Consequently, the BMA has been working with Tony Goldstone and actuaries to develop a pension and AA tax modelling tool.

The 50:50 scheme will solve this problem

You may be aware that the chancellor has suggested that increased pension flexibility rather than a change in pension taxation is the solution to this problem. One option that has been discussed is the so called 50:50 scheme that is currently used in the Local Government Pension Scheme. This was initially introduced to help encourage lower paid members to contribute towards a pension rather than to help deal with problems with the AA. Under such a scheme, a member pays contributions on only half of their pensionable pay and in turn receives half of the normal accrual. So, for example, for an NHS scheme member with a pensionable pay of £100,000 who was accruing years in the 2015 scheme, they would pay contributions on £50,000 and accrue pensionable service at 1/108ths rather than the usual 1/54ths.

However, the BMA has modelled the 50:50 option and it is **not** a solution to the AA taxation problem for a number of reasons. It is insufficiently flexible. In some years consultants will be paying too little into their pension, thereby reducing their final pension, and in others they will be paying too much into their pension and incurring additional tax charges. Second, unless this is associated with recycling of the employer's pension contributions, the value of these (currently 20.6%) on the portion of pay that is effectively non-pensionable is lost, thereby reducing the total reward package for consultants. The BMA has modelled 50:50 and unless this is accompanied by recycling of the employer's contributions this option results in a significantly lower pension. In fact, in many cases the pension is lower than if you have simply paid the tax charges. The BMA is clear that the only way to fix this problem is by fundamental tax reform. This view is shared by two former pensions ministers and the Institute for Fiscal Studies who described the fact that a person's income can fall following a pay rise as 'absurd'. The BMA are calling for the annual allowance and in particular the tapered AA to be scrapped in defined benefit schemes.

FICTION

This is a cleverly designed stealth tax targeting doctors

It is certainly the case that separate changes to the pensions taxation rules and the NHS pension scheme(s) have resulted in a perfect storm that it is targeting doctors working within the NHS. However, the BMA were sceptical that the Government would develop a taxation policy that leaves doctors with little choice but to take early retirement or reduce the work they do for the NHS, abandon leadership, research and teaching positions and no longer strive for excellence. Yet that is exactly what the current pensions taxation policies are forcing doctors to do, despite these doctors wanting to continue working for their patients. In our discussions with the Government it was clear that and these were in fact entirely 'unintended consequences' of a change in tax policy. This has also been confirmed publicly by the Secretary of State for Health and Social Care. Rather than trying to paper over the cracks, the BMA urges the Government to fix the problem at source and abolish the AA in defined benefit schemes.

FICTION

All consultants should leave the NHS pension scheme(s)

The BMA is **not** saying that consultants should leave the NHS pension scheme(s). For many scheme members the NHS pension scheme(s) continue to offer good value for money and it makes sense for doctors to remain in the scheme for as long as possible. The problem is that there are unfair taxation 'traps' that mean pension scheme membership is punished by unfair and unreasonable methods of calculation of pension growth that lead to huge additional tax charges. These can completely swing the cost-effectiveness of the scheme and make ongoing scheme membership unaffordable at certain periods, this is particularly the case if consultants don't take steps to reduce their income by limiting the work that they do. Some consultants may choose to leave the pension scheme for extended periods to attempt to mitigate their exposure to AA charges but this may result in significant reduction of risk benefits such as death in service and ill health retirement benefit. Consultants wishing to adopt such a strategy must ensure they have adequate alternative provision for these benefits.

FACT

You need to reduce your NHS sessions in order to protect yourself from these unfair additional tax charges

There are a very limited number of ways available to protect yourself from these potentially huge AA tax charges. As noted, AA tax charges are closely related to earnings, so limiting earnings is a key way of reducing exposure to the likelihood of receiving an AA tax charge. For most consultants the only way to do this will be to reduce the amount of work they do for the NHS – either through reducing the number of PAs they do or by abandoning other, discretionary work such as additional leadership roles or striving for recognition of the excellence of their clinical work. This is what the BMA has been lobbying governments and their agencies to try to avoid. This unfair tax has a significant impact on the NHS and the patients it serves and the power to resolve this issue rests **entirely** with those governments and their agencies. Without resolving the problem by removing the AA and in particular the tapered AA there are almost no other actions that are able to offer effective protection from these additional and unfair taxes.

FICTION

You can take your time, see what happens and take measures at a later date

This is unwise. It is vitally important to model your own exact circumstances as it is difficult to generalise. The optimal changes that you can make will be very individual to your own circumstances and depends not only on your earnings (both pensionable and non-pensionable) but the number of years of service in your legacy pension scheme and even the month in which you may receive an incremental payrise. Many consultants will need to take action much more rapidly if they are to protect themselves against a tax charge for the current financial year. As previously noted, if consultants take no action, receiving an AA charge will be an annual feature of the financial year for most consultants. We have also described that one of the few actions that consultants can take to help protect themselves is to reduce the amount of work they do for the NHS. It is true that some consultants could achieve this by reducing flexible additional sessions such as Waiting List Initiative work or by declining to take on additional cover work such as covering rota gaps or by declining additional locum work. These reductions can be applied fairly quickly by the consultant and therefore have an effect this financial year.

For other consultants a more enduring solution may be required, such as reducing APAs (additional PAs), as is their contractual right. It is important to note that for most APAs a period of notice is required for either party to terminate this agreement. This is usually three months but may be a different, locally negotiated period of time. The notice period implies that there would be at least a three-month period before any financial impact was felt – bearing in mind that we are now into the third month of the current financial year that would mean a decision to drop an APA would not have an impact until half-way through the financial year. You may need to take action **as soon as you can.**

BMA
British Medical Association, BMA House,
Tavistock Square, London WC1H 9JP
bma.org.uk

BMA 20190329